

## COMMENTS

### TAX EXPENDITURES, THE SIZE AND EFFICIENCY OF GOVERNMENT, AND IMPLICATIONS FOR BUDGET REFORM, LEONARD BURMAN AND MARVIN PHAUP

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**T**HIS IS A HANDSOME ANALYSIS OF A PHENOMENON that is much observed and talked about. It provides a nice formalization of the idea that there is a fiscal illusion in which the public is willing to accept tax expenditures more readily than outlays. While the conclusions are intuitive, the model is useful to all those who will not believe common sense until it is expressed with at least one Greek letter – and it is accompanied by fine graphics for old-school analysts who like to see pictures.

As someone who favors smaller government, I am appreciative of what this paper says about the bias from this illusion. Too many nominal conservatives object to the concept of tax expenditures. This paper says what cannot be said too often: that the concept is valuable to those who want government to be smaller. Ultimately, the tax expenditure budget is about identifying big government in drag.

The paper follows up nicely with some possible remedies. These fall into two categories: changes in budget presentation and changes in budget process. All in all, it is a straightforward, serious attempt to grapple with a real budgetary problem. However, I have a couple of quibbles. But more seriously, I question the motivating assumption of the model, which leads me to think that the analysis may not be useful as it could be. Let me start with the quibbles.

First, the authors imply – if not right out announce – that one of the problems with tax expenditures is that they are like entitlements and mandatory spending in that they are relatively uncontrollable. This is a standard observation and is at least half right; the analogy to entitlements is on the mark.

But I think the idea of the contribution of entitlements to our budget problem is overplayed. The truth is, entitlements are a good budgetary idea. All government spending should be thought of in terms of figuring out what it is we want to do and under what conditions we will pay out money, and then doing that. The economy is served well by some foreknowledge of what the government is up to. To illustrate: think if we handled taxes the way we do discretionary spending. Just months in advance

of the tax year (if we are lucky), Congress decides how much it wants to collect, and then it decides which tax bases to emphasize, and then – and only then – based on its best estimate of the likely tax base, it tells everyone what is going to be taxed and by how much. No one would like that – and it would not be very good.

Admittedly, if you could really randomize the process you could establish a neutral tax based on the idea that no one could have time to respond to incentives. But I think that most of us would argue that stability of the tax system is valuable. And I would posit that stability of the spending system is too. In the end, the problem with entitlements and tax expenditures is not that they are uncontrollable, but that they are not controlled – something different, I would contend.

My second quibble is something I think the authors would agree with, but is a matter that gets insufficient attention. The tax system is a perfectly appropriate place for some kinds of spending. Just about any kind of outlay that you want to means-test needs an administrative mechanism that takes into account income. The income tax is an ideal place for that.

In addition to means-testing, some tax expenditures stem from administrative convenience. One of the biggies, the tax exemption for employer-provided health insurance, is partly due to this. Group policies are full of cross subsidies. It can be complicated to actually come up with a value to impute to employees. You can end the deduction for employers, but the bias still remains for employees of untaxed entities, such as state and local governments and non-profits. The administration issue may not be compelling in itself, but if you are also trying to achieve some social goal, the expenditure again may belong in the tax system.

So we do not want to dump all tax expenditures – and therefore we do not want to create a uniform bias against them. There is nothing new in this observation for the authors. They know it already, but it is a useful thing to recall in public debate.

So then, what is my major problem with the analysis? It is this: I do not think that the fiscal illusion associated with “cutting” taxes is the principal driver behind the growth and sanctity of tax expenditures. I will readily admit that the illusion does create some bias. Any of us who has worked in the Congressional Budget Office (CBO) know how much it is preferred to reduce taxes over increasing spending. We can also see the bias in the flip side of tax expenditures – efforts to characterize revenues as offsetting collections, income to the government that gets subtracted from spending, so that instead of increasing taxes we decrease spending. But I do not think that the ability to disguise spending is the reason so many policy makers reach for the tax code.

I think that the reason has to do more with avoiding the messiness of setting up mechanisms to administer spending programs. If you want a new spending program, you have to set up a bureau or department to administer it. Even if you park it in an existing agency, there is generally some acknowledgment of the need for extra resources to run it.

A tax expenditure administers itself; it is almost entirely automatic. To have an equivalent spending program, the government would have to send blank checks to people, already signed by Uncle Sam. Each person would fill in the amount for which he qualifies. He determines himself what this is by adding up some numbers on receipts and 1099s. But he does not send this documentation in, just a form that tells the government what he wrote the check for, subject to some low probability that the government will come back later and want to look at his addition.

No outlay program would be allowed to do this. And that is a big part of the appeal of new tax expenditures. Whatever new complaint the public brings to lawmaker attention can be ameliorated without the trouble and fuss of setting up a program. Want to do something for education? Create a new deduction for teacher spending on materials for their classes. Want to promote energy efficiency? Give people a credit for purchasing supposedly

energy-efficient products. Want to just spread money around for whatever reason? Just let businesses keep more by whatever mechanism is easier than actually creating a board that will review private proposals and approve subsidies for them.

Of course, there is a programmatic and administrative cost; but it is hidden. There is an illusion. But it is not so much a fiscal illusion as much as a bureaucratic one. This helps explain why we so readily reach into the legislator’s toolkit for tax expenditures, but it does not explain why they are so difficult to eliminate. In that regard, I do not think tax expenditures are unique. This is true of entitlements as well. Keep in mind that it was not a tax expenditure that earned the title of “third rail of American politics. And sacrosanct spending includes a number of discretionary spending programs as well – try cutting highway spending.

What all these have in common is that people know exactly who is getting money from them. They are not like the many things the government does – such as the Weather Service or National Forests that reach people at one remove. In the end, the constituency for big government is not who receives services but who receives payments.

So where does that leave us? For one, it means that changing budgetary measures will not help much. It really does not matter much which side of the ledger these items wind up on. But that is probably true even if you accept the motivation of the authors’ model. Indeed, I have to say that I am charmed by the faith that the public actually looks at these numbers. And there is a sweet naivety to the notion that they will play any role in the rantings of those purveyors of public outrage to whom so many people listen. Those guys make up their own numbers in any case.

Some of the process reforms might be helpful; we have seen legislators respond to those incentives. But if we go that route, I would think hard about designs that help lawmakers distinguish between tax expenditures that actually reduce administrative costs and those that merely hide those costs. That is the real trick.